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Global Crisis Avoided, Robust Economic Growth Sustained

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Abstract

This paper explores how the ongoing crisis, the policy responses to it, and the post-crisis global economy will impact China's medium-term prospects for growth, poverty reduction, and development. The paper reviews China's pre-crisis growth experience, including its relationship to global economic developments. It discusses the pace, composition, sources, and financing of growth during 1995–2007, and the impact of key external and domestic influences. The paper also analyzes the immediate impact of the global crisis on China's economic performance in 2009 and its likely impact in the short run. It then discusses the government's policy response, with a particular focus on the fiscal and monetary stimulus measures. Finally, the paper explores China's medium-term growth prospects in light of the crisis and the key policies for moving to a robust and sustainable growth path post-crisis.

This paper—a product of the Economic Policy and Debt Department, Poverty Reduction and Economic Management Network; and the Poverty Reduction and Economic Management Department, East Asia and Pacific Region —is part of a larger effort in these departments to identify and address developing country vulnerabilities in the face of financial and economic crisis. Policy Research Working Papers are also posted on the Web at http://econ.worldbank.org. The authors may be contacted at gvincelette@worldbank.org, amanoel@worldbank.org, ahansson@worldbank.org, and lkuijs@worldbank.org.

China: Global Crisis Avoided, Robust Economic Growth Sustained[1]

By Gallina Andronova Vincelette, Alvaro Manoel, Ardo Hansson and Louis Kuijs

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I. Introduction

The financial and then economic crisis, which has engulfed the world since 2008, will shape the growth and development prospects of developing countries for the foreseeable future. This paper explores how the ongoing economic crisis, the policy responses to it, and the postcrisis global economy will affect China's medium-term prospects for growth, poverty reduction, and development.

The paper begins with a review of China's precrisis growth experience, summarizing China's growth, poverty reduction, and human development achievements over the 30-year period of reform and globalization. It then discusses the pace, composition, sources, and financing of China's growth during 1995–2007 and the impact of key external and domestic factors. We identify several challenges emanating from China's precrisis policies and assess the impact of the global crisis on China's economy in 2009, as well as its likely impact in 2010. We then examine the government's policy response, focusing on fiscal and monetary stimulus measures. We conclude with a look at China's medium-term growth prospects and the main policies needed to move it to a robust and sustainable growth path.

II. Precrisis, Preboom, and the Global Boom

Since 1978, China's government has consistently undertaken economic reforms and opened up the economy to the outside world, fueling impressive economic growth. China's gross domestic product (GDP) has grown by an average annual rate of nearly 10 percent in real terms since 1978, compared with 4 percent for all developing countries. Although China's per capita GDP is still modest (about $3,300 in 2008), it had become the world's third largest economy by 2007 (measured in current exchange rates). China's share of world trade in 2008 was 10 percent, compared with the U.S. share of 12 percent and the European share of 16 percent. And in 2009, China edged out Germany to become the world's largest exporter.

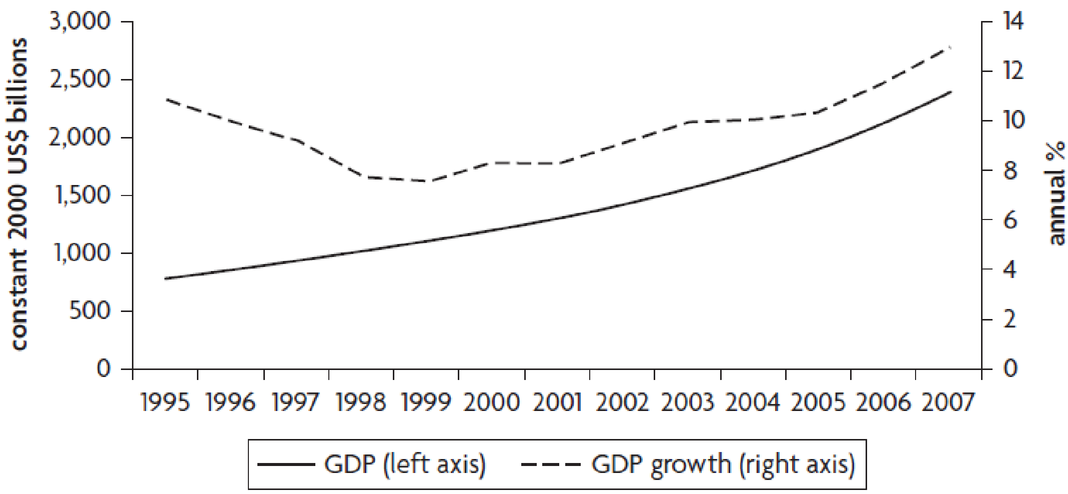
China's strong growth has sharply reduced the share of the population in poverty. Using China's official poverty standard, the poverty rate in rural China fell from 18.5 percent in 1981 to 2.8 percent in 2004, and the number of rural poor fell from 152 million to 26 million. Measured by the World Bank poverty standard, China's poverty reduction has been even more striking. The fraction of the population below the poverty line declined from 65 percent to 10 percent in this period, and the absolute number of poor fell dramatically—from 652 million to 135 million, or by over half a billion people. Measured by the new international poverty standard of $1.25 per person per day, poverty levels are higher, but the decline since 1981 has been no less impressive—from 85 percent in 1981 to 27 percent in 2004. Preliminary analysis of trends during 2004–07 suggests further progress in poverty reduction, with poverty measured by the World Bank standard likely to have fallen further to 4 percent from about 10 percent.[1]

China has also made great strides in improving human development indicators. It has already achieved most of the Millennium Development Goals, or is well on the way to achieving them. As a result, China is now at a very different stage of development than it was at the dawn of the economic reforms at the start of the 1980s. It has become a booming lower-middle-income country strongly integrated into the global economy.

Economic Performance before the Crisis

During the precrisis period, China posted impressive growth rates. Average annual growth between 1995 and 2007 was 9.7 percent. The economy experienced a slight dip after the Asian financial crisis of 1998, but rebounded quickly in the following years (figure 1).

Figure 1. China GDP Growth Rate, 1995–2007



Source: World Bank.

China's strong economic performance in this period was influenced by both external and domestic factors:

- *During 1995–2001, growth in global output and export demand was robust and stable.* As financial markets developed, developing countries' access to financing became easier, although flows were still moderate and spreads fluctuated. Primary commodity prices were generally low. During this period, China, like its neighboring economies, was hurt by the Asian crisis. While it was not at the epicenter of the crisis, it did not remain unscathed, and its growth decelerated until 1999.
- *The global picture began to change around 2002.* Although growth in advanced countries slowed beginning in 2001 and throughout the boom period, growth accelerated in developing countries, including China, with trend growth appearing to decouple from that of developed countries. Regionally, the impact of the Asian crisis had long subsided, partly because of improved policies and technology, but also because of a more favorable global economic environment. With ample global savings and financial innovation, risk premiums fell to unprecedented lows.
- *International trade and capital flows accelerated.* Trade flows grew very rapidly, with expanding global demand facilitating export-led growth. During much of this period, China's exports grew at more than 20 percent a year, in real terms. As the global economy boomed, commodity prices increased sharply. Together with high export

demand and easy financing, this contributed to an investment boom in the developing world. Capital flows to developing countries (mostly to the private sector) were around five times their average levels before 2002. China, however, bucked this trend by becoming an even larger net exporter of capital, with current account surpluses averaging 6.1 percent of GDP during this period. Stock markets boomed globally—and especially in developing countries.

- *China's growth was also fueled by the fruits of reforms and public investments that made labor and capital more productive.* Key reforms—including those implemented in response to the Asian crisis—consisted of China's accession to the World Trade Organization and the reforms it catalyzed; the restructuring and privatization of state-owned enterprises (SOEs); the privatization of social housing; policy adjustments that facilitated a sustained flow of "surplus" labor from rural areas to urban areas, engendering the process of urbanization; and improved macroeconomic management. Major investments were made in areas such as roads, ports, and airports. A significant share of China's post–Asian crisis investment served to remove critical bottlenecks to growth, generating high rates of return and laying the foundation for the next wave of development.

Growth in China has been increasingly capital intensive, with high (and rising) savings and investment rates. A look beyond aggregate growth rates reveals several key characteristics of China's recent growth pattern.[2] Analyses of the sources of China's economic growth using a growth accounting framework suggest that capital accumulation has played a large and increasing role in China's growth process:

- Investment in factories, buildings, and infrastructure increased from 35 percent of GDP in 2000 to about 43 percent in 2007. This was accompanied by a corresponding increase in gross national saving from 37 percent of GDP to about 54 percent.
- The contribution of capital accumulation to labor productivity growth increased from 2.9 out of 6.4 percent a year in 1978–94 to 5.5 out of 8.6 percent in 1994–2009 (box 1).
- Contrary to popular belief, China's total factor productivity (TFP) growth has been higher relative to most other countries; most of the difference in GDP growth performance between China and other countries has been due to increasing levels of capital accumulation.

The bulk of China's investment has been financed domestically. Foreign direct investment (FDI) played an important role in China's development, particularly in transferring technology and linking China to global markets. However, at 3–4 percent of GDP, FDI has not been the main source of financing for China's growth. Furthermore, FDI as a share of GDP was actually lower during 2002–07, when China's growth rate accelerated further. FDI as a share of GDP fell from 4.2 percent in 1995–2001 to 3.0 percent in 2002–07. Instead, domestic savings has been the key source of financing in China. Thus, even as the investment-to-GDP ratio increased by 8 percentage points from 2000 to 2007, savings far outpaced investment. As a result, China's external current account surplus rose from 1.7 percent of GDP in 2000 to almost 11 percent of GDP in 2007.

Box 1. Growth Accounting for China

Physical capital accumulation in China has been sizable and growing. Several studies have used growth accounting to analyze the sources behind China's rapid growth of the past 25 years. These studies find that, respectable productivity growth notwithstanding, the contribution of physical capital accumulation has been of major significance, reflecting the increasing investment-to-GDP ratio. Capital accumulation's contribution to GDP growth was much larger in 1994–2007 than it was in 1978–94, reflecting the rapid investment growth in the past decade. Kuijs and Wang (2006) conducted a growth accounting exercise for 1978–2004 using consensus assumptions on the key parameters. They found that the contribution of capital accumulation to GDP growth was considerably larger in 1994–2007 than in 1978–94, reflecting the rapid investment growth in the past decade, while TFP growth declined relative to the first period.
What explains labor productivity growth? A useful way of looking at these trends is to decompose labor productivity growth into TFP growth and the contribution of capital accumulation (higher K/L). The contribution of capital accumulation to labor productivity growth increased from 2.9 out of 6.4 percent a year in 1978–94 to 5.5 out of 8.6 percent in 1994–2009 (table B1.1). This is very high, and explains more than two-thirds of the difference in labor productivity growth between China and other countries and regions. Under most assumptions that were examined, including the "consensus" assumptions that underpin the results shown in the table, TFP growth is estimated to have declined over time. With overall employment growth slowing, the contribution of labor growth has been modest, especially over the last decade.

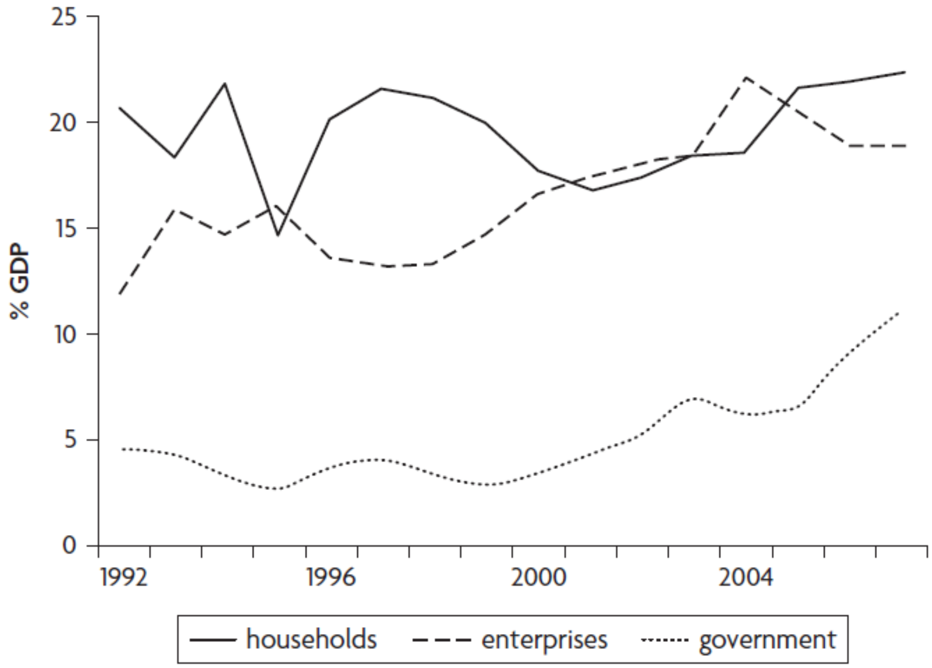
Table B1.1 Sources and Aspects of Growth, 1978–2015 ***(average annual increase, %)***

	1978–94	1994–2009	2009–15
GDP growth	9.9	9.6	8.3
Employment growth	3.3	1.0	0.2
Labor productivity growth	6.4	8.6	8.1
From TFP growth	3.0	2.7	2.2
From higher H/L	0.5	0.3	0.5
From higher K/L ratio	2.9	5.5[a]	5.2
Memorandum items (%)			
Investment/GDP ratio (period avg.)	30.1	39.8	47.7

Source: NBS (National Bureau of Statistics); World Bank staff estimates.
Note: Methodology as in Kuijs and Wang (2006), but with human capital.
a. The contribution from higher K/L is much higher in 2000–09 than in 1994–99.

Household savings are relatively high in China; but this has not been the main force driving the impressive increase in domestic savings in the past 10 years. Households in China save more than those in the Organisation for Economic Co-operation and Development countries, partly because of the lack of social safety nets. However, with household income accounting for some 60 percent of GDP, and with households typically saving 25–30 percent of their income, China is not out of line with its Asian comparators. Household savings declined somewhat as a share of GDP in 1995–2001 and rose somewhat after 2001 (figure 2).

Figure 2. Saving and Investment in China



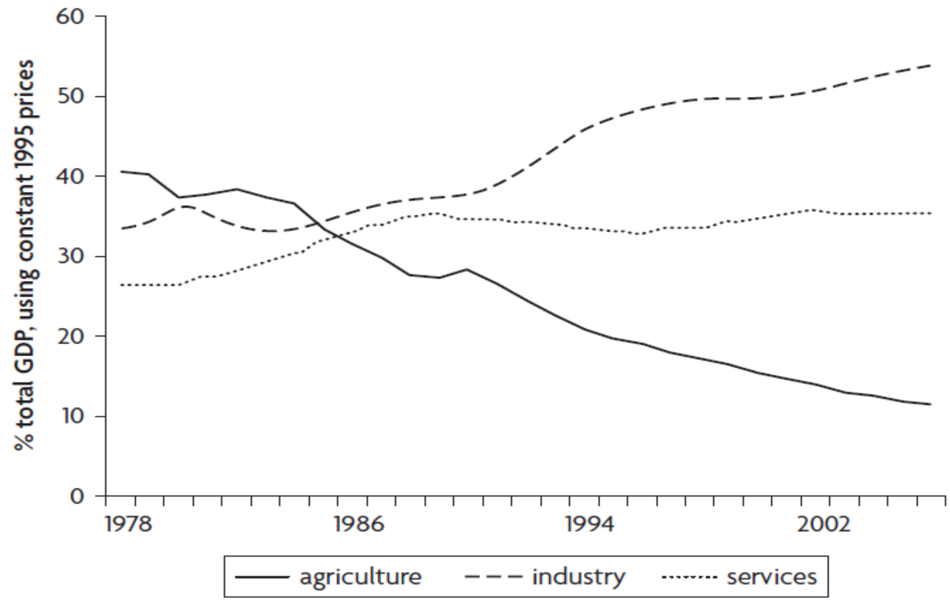
Source: CEIC China Database; World Bank staff estimates.
Note: Flow-of-funds data.

Much of the increase in China's domestic saving came from the enterprise sector and the government.[3] Since the late 1990s, rising enterprise savings have helped increase economywide saving under China's capital-intensive, industry-led growth model,[4] which has boosted productivity in industry. With surplus labor in agriculture still sizable, wages lagged productivity, especially at the lower end of the wage scale, even as skilled workers saw wages rise more rapidly. As a result, enterprise profits and savings increased as a share of total income. As for the government, its revenues have grown sharply because so much of it derives from taxes on corporate and industrial activity. Government revenues from land sales have also increased over time.

Thanks to China's traditionally conservative fiscal policy, government expenditure has been less than revenue. In particular, the government's current spending has lagged because Beijing has traditionally set aside a large share of revenues to finance investment.

Much of China's GDP growth since the early 1990s has come from the explosive growth in industrial production. Industrial value added increased by an annual average rate of 12.3 percent during 1990–2007, and the share of industry in GDP (in current prices) rose from 41 percent to almost 49 percent—among the highest for any country since the 1960s. In fact, the increase would have been larger but for declining relative prices in industry. In constant 1995 prices, the share of industry in GDP rose from 37 percent in 1990 to 54 percent in 2007 (figure 3). During 2003–07, the industrial sector contributed 60 percent of total GDP growth; just 5 percent was from agriculture and 35 percent was from the services sector.

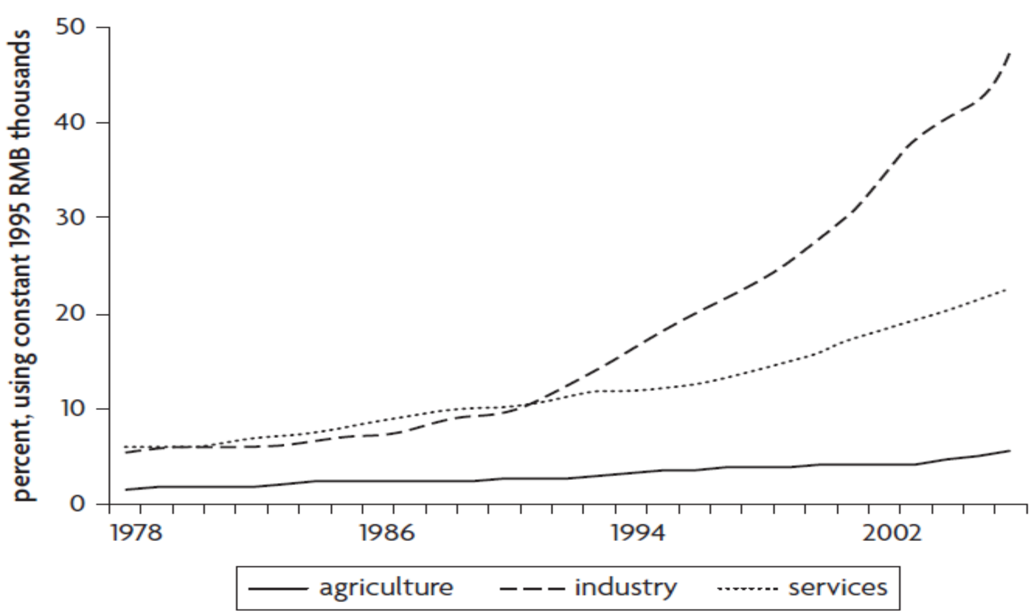
Figure 3. Industry Has Driven Growth



Source: NBS; authors' estimates.

On the whole, more than 80 percent of the growth in industry during 1993–2005 was due to higher labor productivity (figure 4) rather than more employment. This is attributable mainly to the large-scale investment effort and increased capital-to-labor ratio. Of course, the low growth of industrial employment in this period masks important net movements of labor out of SOEs into private sector firms.

Figure 4. Labor Productivity in Industry Has Soared



Source: NBS; authors' estimates.

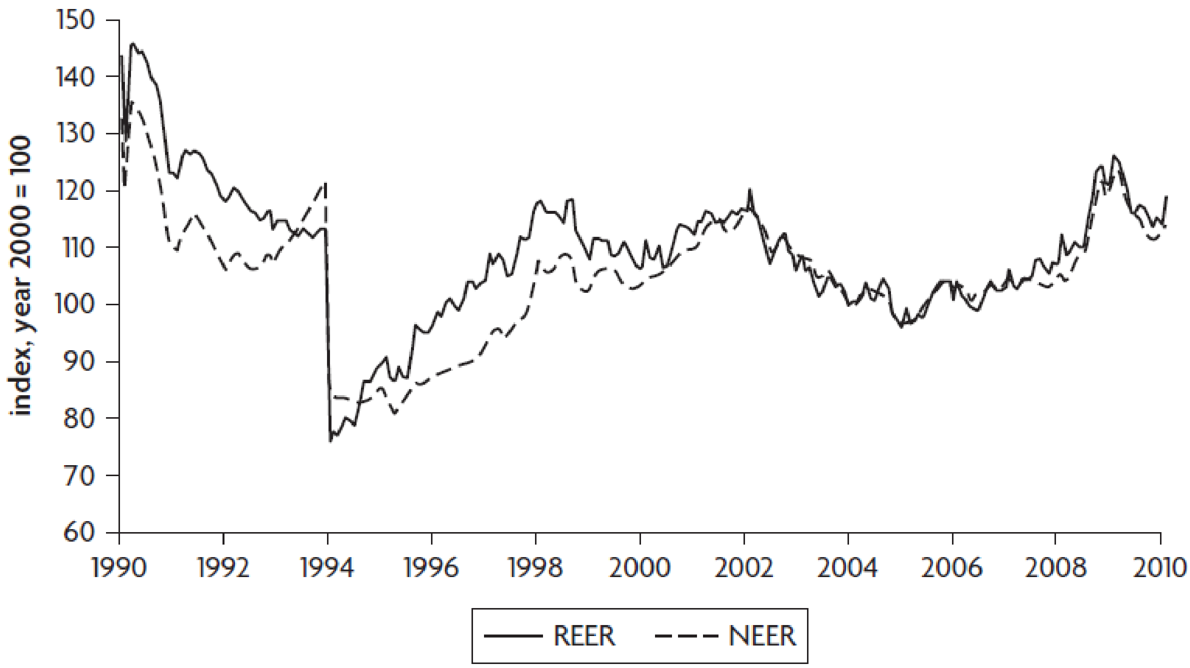
As in other successfully industrializing countries, Chinese government investment has been a key component of industry growth. Public investment, as reported by flow-of-funds data, averaged 6 percent of GDP during 1995–2007, including capital transfers. Rising levels of public investment were supported by strong growth in tax collections and other revenues (for example, land transfers by local governments) and by limits on current spending. As a substantial amount of investment is financed through special-purpose municipal investment companies, total public investment was even higher.

China's traditional capital-intensive, industry-led growth pattern is amplified by its policies. The government has favored industry and investment over the services sector and domestic consumption in several ways:

- *Policies have encouraged saving and investment.* Government spending has been geared to investment in physical infrastructure instead of current spending on health and education. Apart from its obvious direct effect, this has increased precautionary saving by households. In addition, investment has been encouraged by several features of the tax system, by the exemption of SOEs from paying dividends, and by the channeling of capital transfers and loans to SOEs and SOE-type entities.
- *Investment in industry has been encouraged through the financial system.* Commercial bank lending rates have been kept low for those with access to financial markets. Access has been easier for large industrial firms, which has promoted capital-intensive industrial development. The People's Bank of China reports that small and medium enterprises)—which are far more prevalent in services than in industry—account for more than half of GDP, but receive less than 10 percent of total bank loans.
- *Industrialization has also been promoted by keeping the prices of key inputs low.* Besides capital, these inputs include energy, electricity, utilities (including water), land, and low pricing of environmental impacts.
- *Promoting industrial development has meant that services-sector development was not given priority.*[5] Recognizing this, China's State Council in March 2007 called for opening up several services sectors—including telecommunications, railways, and civil aviation—to private and foreign investors and for improving the legal framework to stimulate the services sector.
- *The containment of migration into urban areas has shaped the capital-intensive nature of growth.* The speed and nature of migration has been affected by the Hukou system of residency permits, regulations discriminating against migrant workers, the nonportability of labor and social benefits, and land tenure policies. As a result, much of the migration has taken place in the form of a growing "floating," rather than permanent, population.

While these policies have contributed to China's export-led growth model, exchange rate policy has also been instrumental. In particular, the reluctance to let the exchange rate appreciate in line with the rapid productivity gains in manufacturing—which have outpaced those for most of China's trading partners—has stimulated the production of tradable goods and services. Nominal and real effective exchange rates for the renminbi (the Chinese currency, whose unit is the yuan) are now broadly at their 2000 level (figure 5). But the exchange rate policy in China is evolving: on June 19, 2010, the government decided to return to a managed floating-exchange-rate regime that allows for movements in the exchange rate based on market supply and demand and with a reference to a basket of currencies.

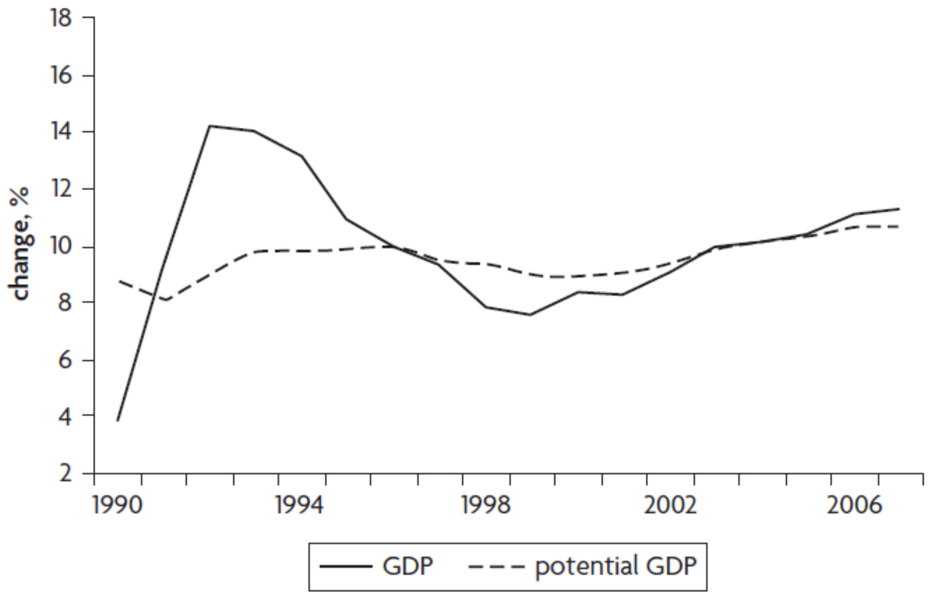
Figure 5. China's (Effective) Exchange Rate Trends



Source: CEIC China Database; World Bank staff estimates.
Note: NEER = nominal effective exchange rate, REER = real effective exchange rate.

The capital-intensive, industry-led growth model, accompanied by an undervalued currency, has served China well in many respects. The high savings and investment, combined with respectable rates of technological progress, have led to rapid growth of China's production capacity. In recent years, potential GDP growth—or the capacity to produce—has been rising in line with actual GDP growth to more than 10 percent a year (figure 6). This means that the economy can grow rapidly without running into the kinds of constraints often faced by emerging-market countries, such as high inflation, large current account deficits, and bottlenecks in the real economy. Thus, the policies cited above have been key elements of a pro-growth policy package that also includes good macroeconomic management, trade liberalization, a favorable setting for FDI, good infrastructure, and pro-growth local governments.

Figure 6. Actual and Potential GDP Have Grown Steadily in Recent Years



Source: NBS; World Bank staff estimates.
Note: Potential GDP is estimated using a growth accounting framework with Cobb-Douglas production function.

Nonetheless, China's capital-intensive, industry-led growth model has also raised several risks:

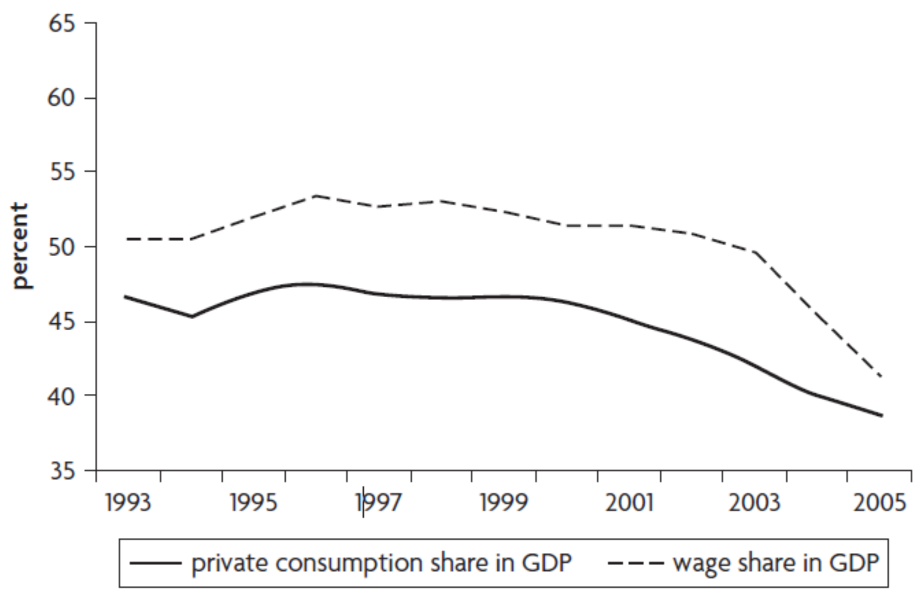
- *This growth pattern has created fewer urban jobs than would a more labor-intensive model and has increased urban-rural inequality.* Industry creates fewer urban jobs than does the services sector, and during 1993–2007, more than 80 percent of the growth in industry came from higher labor productivity instead of from new employment. Indeed, industrial employment grew by just 2.3 percent per year during 1993–2007, compared with annual value added growth of 11.7 percent. Since the mid-1990s, this has limited the movement of people out of agriculture and the rural areas, where productivity and income are much lower (productivity in agriculture is about one-sixth that of the rest of the economy). While the share of total employment in agriculture fell rapidly during 1978–95, the share did not fall much from the mid-1990s until around 2003. The reduction seems to have accelerated since then, and the share fell to less than 41 percent in 2007. Nonetheless, this is high relative to other countries at a similar stage of development. The divergence of productivity, however, has underscored rural-urban income inequalities. It is an important reason for the widening in the rural-urban income gap from 2.2 in 1990 to 3.3 in 2007, as well as in the increase in overall income inequality as measured by the Gini coefficient.
- *Much of China's growth has stemmed from the increased production of manufactured goods, with a tendency to expand current account surpluses.* Under the investment-heavy pattern of growth, and with surplus labor in agriculture keeping wage growth low relative to the rapid productivity gains, production in China has tended to outstrip

domestic demand. From the perspective of China's external balance, the strong growth of manufacturing output means continued strong export growth; however, import growth has been more subdued, partly because of increasing import substitution. As a result, the current account surplus is widening steadily.

• *Industry-led growth (including construction) has made particularly intensive use of energy, primary commodities, and other resources, with a damaging effect on the environment.* China's overall reliance on these inputs is high due to the size of its industrial sector.

The flip side of the increase in enterprise income and buoyant tax revenues is the decline, as a share of GDP, in wage and household incomes (figure 7). This decline has been the main cause of the falling share of consumption in GDP since the late 1990s. A decline in households' investment income, driven by declining interest rates, has amplified the reduction in the share of household income in GDP.[6]

Figure 7. The Wage Share Has Declined



Source: National Resource of Statistics. Wage share data are from *Statistical Yearbook*.

Precrisis Policies and Post-Crisis Challenges

• How attributable were the rate and pattern of Chinese growth during the precrisis boom (2002–07) to improved longer-term growth potential, and how attributable were they to cyclical factors?

• How—and to what extent—did the precrisis global boom affect China's potential growth rate?

• Did China's precrisis policies increase or mitigate its vulnerability to external shocks and global reversals?

China's growth rate during 1995–2007 is mainly a reflection of a high and relatively stable underlying growth potential, and to a lesser extent cyclical factors. China's potential GDP growth rate has increased since the late 1990s, after moderating earlier (figure 6, box

1). On average, actual growth during 1995–2007 was in line with potential growth, being slightly above potential growth in 1995 and 2007, while falling nearly 2 percent below it during the Asian crisis.

The increase in estimated potential growth during the current decade was due primarily to a rise in the investment rate from 37 percent in 1995–2001 to 42 percent in 2002–07. These high and rising investment rates reflected the policies discussed earlier, as well as a strong outlook for (and actual performance of) China's exports and capacity bottlenecks in some sectors. These high investment rates and the continued robust underlying TFP growth were also supported by a favorable external environment and a solid record of reform and macroeconomic management. Tentative estimates suggest that the economy was operating at more than full capacity in 2006–07, before it was hit by the global financial and economic crisis of 2008.

Despite China's high and stable underlying growth potential, cyclical factors (such as net exports and FDI) have also been important. In particular, the 2.6 percentage point increase in the contribution of net exports to growth was fueled partly by strong external demand. While access to external financing was negligible in aggregate terms, FDI has been important for supporting growth through structural changes and increased productivity. More than half of China's exports are produced (at least partly) by foreign firms, and FDI has had positive spillover effects on other firms (Xu and Sheng 2010).

While internal migration has been a critical part of China's growth story, external migration has not been important. Recorded private transfers averaged only 0.7 percent of GDP per year during 1995–2007.

China's precrisis policies helped protect the economy against external shocks and global reversals. These policies also put China in a strong position to respond to the crisis with substantial monetary and fiscal easing. The main monetary and fiscal policies included the following:

- *Prudent fiscal policies*, which left China with generally low budget deficits and reported public debt below 20 percent of GDP as it entered the crisis
- *Fairly prudent monetary policy*, with tightened controls on bank lending during periods of perceived overheating (a preemptive "deleveraging," which left banks with relatively low loan-to-deposit ratios)[7]
- *A cautious approach to financial sector liberalization* and opening up of the capital account

Partly because of these policies, China substantially increased its foreign reserves and kept external debt at a low level. China accumulated nearly $2 trillion of foreign reserves, equivalent to more than 20 months of imports, and its external debt was only about 10 percent of GDP.[8]

The evolution of China's macroeconomy during the precrisis period and the role of its economic policies reflected the authorities' degree of policy maneuverability. First, the average annual growth rate during 1995–2007 was impressive (9.7 percent), suffering only a slight dip after the Asian crisis (figure 1). Second, growth has been increasingly capital intensive, and much of it has been financed domestically—largely by the enterprise sector and the government (box 1 and figure 2). And third, the economy has seen periods of overheating, when GDP outpaced potential GDP growth, creating a positive output gap. This happened before the Asian crisis and again (in a less pronounced way) during the precrisis period (figure 6), when the economy was beginning to overheat again.

Precrisis policies, however, also left the country exposed to external shocks. To the extent that both structural and exchange rate policies supported rapidly rising exports and trade surpluses, they left China more vulnerable to any sudden decline in export demand. The managed nature of the exchange rate regime also reduced the independence of monetary policy to respond to domestic needs. Moreover, the developments in the equities and private housing markets have introduced new potential transmission channels for external shocks. These markets did exhibit volatility in recent years, especially in the equity market. However, the equity market is less important to the real economy than it is in many other countries, and was thus not the primary channel through which the recent crisis affected the Chinese economy.

III. Global Crisis: Impact and Policy Response

The financial crisis that originated in the developed world intensified in September 2008 in the United States and began to spread globally. Since Lehman Brothers' bankruptcy, many other systemically relevant financial institutions (such as Freddie Mac, Fannie Mae, AIG, Merrill Lynch, and CitiGroup) have faced serious financing difficulties.

In spreading beyond the United States and beyond the financial sector into the international money and capital markets, the previously heavy capital inflows to emerging-market economies quickly and abruptly reversed. These developments did not leave China unaffected.

Channels of Transmission in China

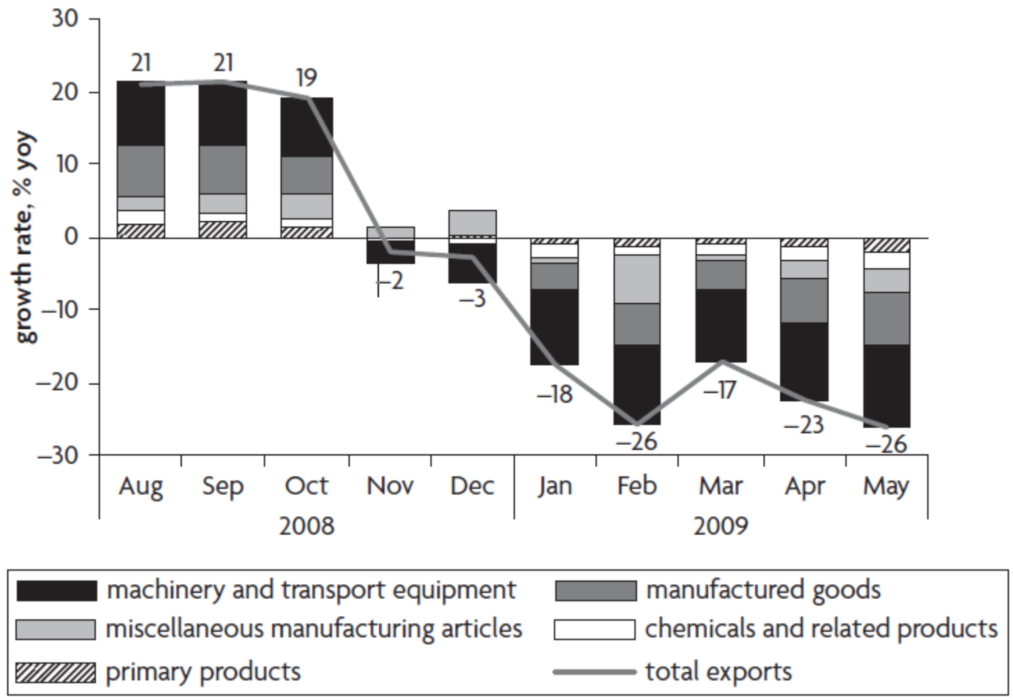
Limited exposure to toxic assets in the developed world and a fairly closed capital account shielded China from the initial financial turmoil of 2008. Furthermore, China's strong fiscal position, highly regulated domestic and recently recapitalized banking sector, large foreign reserves, and low short-term debt helped the country mitigate the external shock.

Despite its favorable initial macroeconomic position, China began to feel the effects of the crisis in November 2008. The impact has been mainly through the trade channel, and not so much through private capital flows and the financial sector.

Trade channel. The real sector has been the main channel through which the global crisis has affected China. In the last quarter of 2008, China's exports declined dramatically. Since the onset of the crisis, exports shifted from 20 percent annual growth to an annualized contraction of more than 25 percent in early 2009. The sharp fall in exports cut growth in the fourth quarter of 2008 to its lowest rate in more than a decade.

A large part of the export contraction was the result of reduced exports of machinery, transport equipment, and manufactured goods (figure 8). Negative growth in China's major trading partners—namely, Europe and the United States, where demand plunged—is the main reason for the steep drop in Chinese exports. Export growth continued to remain subdued throughout 2009, with exports to all markets contracting. This strong decline had additional effects on the real economy, including on investment in the manufacturing sector and in the labor market.

Figure 8. Export Growth (Year on Year) by Commodity Group



Source: World Bank; China Monthly Update (April, May, June, July 2009).
Note: yoy = year on year.

The outlook is for exports to remain restrained given the subdued global economy. As the global economy gradually starts to recover, China's export growth is expected to improve. However, a sharp rebound is unlikely. Import growth, on the other hand, has risen substantially, as the stimulus package has increased China's appetite for investment goods and raw materials. Indeed, real imports rebounded to levels higher than before the crisis. The growth in import volumes has shifted to positive territory for all types of products except electronics and light manufactures, which are affected by still-subdued processing trade. Owing to these strong imports, China's trade surplus is narrowing substantially. And, in combination with the unlikelihood of a sharp export rebound, China's trade surplus may shrink further in the near term before it recovers.

Private capital flows. For many countries, another major source of vulnerability in the face of the global crisis is the massive contraction of private capital flows worldwide. Net private capital flows to emerging economies in 2009 are less than half of the $392 billion of 2008, and far below the record $890 billion in 2007 (see IIF 2009).

While China as a net capital exporter is less affected by such developments, virtually all categories of capital flows to China were hurt after September 2008. Nonresidents continued to sell equities; they also shifted to selling debt securities and selectively withdrawing deposits held with domestic banks. Inflows of FDI slowed sharply as companies began delaying new commitments and new construction. Lending by foreign banks also slowed.

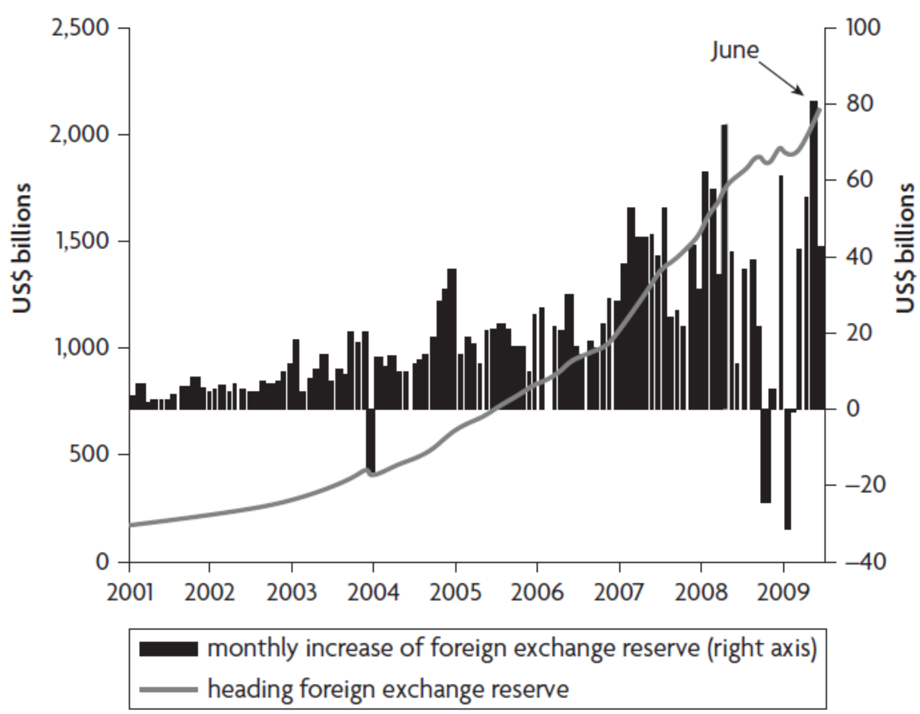
More recently, capital flows to China have begun to recover, and official foreign exchange reserve accumulation has regained strength. After an abrupt decline in foreign investment in the fourth quarter of 2008 and first quarter of 2009, gross FDI inflows revived in the second quarter of 2009. Despite the shrinking current account surplus, which narrowed by about a third in the first half of 2009 (relative to the previous year), China's official foreign exchange reserve accumulation has regained momentum because of valuation gains and net inflows of financial capital (figure 9). The headline reserves figure reached a record $2.3 trillion as of September 30, 2009.

China is likely to continue to attract capital inflows in the near term. Good growth prospects and strong asset market performance are expected to support the attractiveness of China as a destination for foreign capital.

Financial channel. In contrast to other emerging-market economies, China's financial sector has not been seriously affected by the crisis. Its banks were largely untouched because of the following:

- The banking reforms undertaken in early 2000, when the state asset trust cleaned up the nonperforming loans of the banking sector and left the banking system solvent
- The financial system's limited exposure to the toxic assets of the developed world
- The country's minimal reliance on foreign capital for financing economic growth in recent years

Figure 9. Foreign Exchange Reserve Accumulation



Source: CEIC China Database; World Bank staff estimates.

While the Chinese government generally does not report in detail on the holdings of financial entities, some commercial banks have disclosed their low levels of exposure to subprime U.S. mortgages relative to their total investments. For example, the Bank of China (one of China's largest state-owned commercial banks and the largest foreign exchange lender) is among the banks with the greatest exposure to U.S. asset-backed securities. Still, its reported exposure to U.S. mortgage-related securities fell from some 3.5 percent of its overall investment securities portfolio in March 2008 to only 1.4 percent in October 2008.

Instead of relying on foreign savings to finance economic activity, China's banks have deleveraged in recent years. With a considerable saving-investment surplus, China has been able to generate and intermediate financing domestically. Unlike many other emerging markets, the country has remained self-sufficient and was able to continue to lend to domestic agents soon after the crisis broke out. A sharp expansion in domestic bank lending is expected to keep fueling growth in the short term.

Policy Responses and the Strong Fiscal Stimulus

In contrast to other crises, policy makers around the world have responded speedily and forcefully to limit the effects of the rapidly deteriorating financial conditions of late 2008. Like many other countries, China launched expansionary monetary and fiscal policies to offset the fast slowing in economic activity worldwide, cushioning the drag from declining world demand and falling private investment.

Loose monetary policy. China radically changed its monetary policy stance in the last quarter of 2008 following a collapse in export markets, a freezing of upstream industrial activity, and declining housing prices. From a tight monetary policy incorporating inflation expectations, the authorities switched to looser monetary policies aimed at boosting credit expansion and supporting economic activity.[9] The central bank began injecting substantial liquidity into the banking system, starting in the last quarter of 2008 (table 1).

Table 1. Monetary Indicators, 2008–09

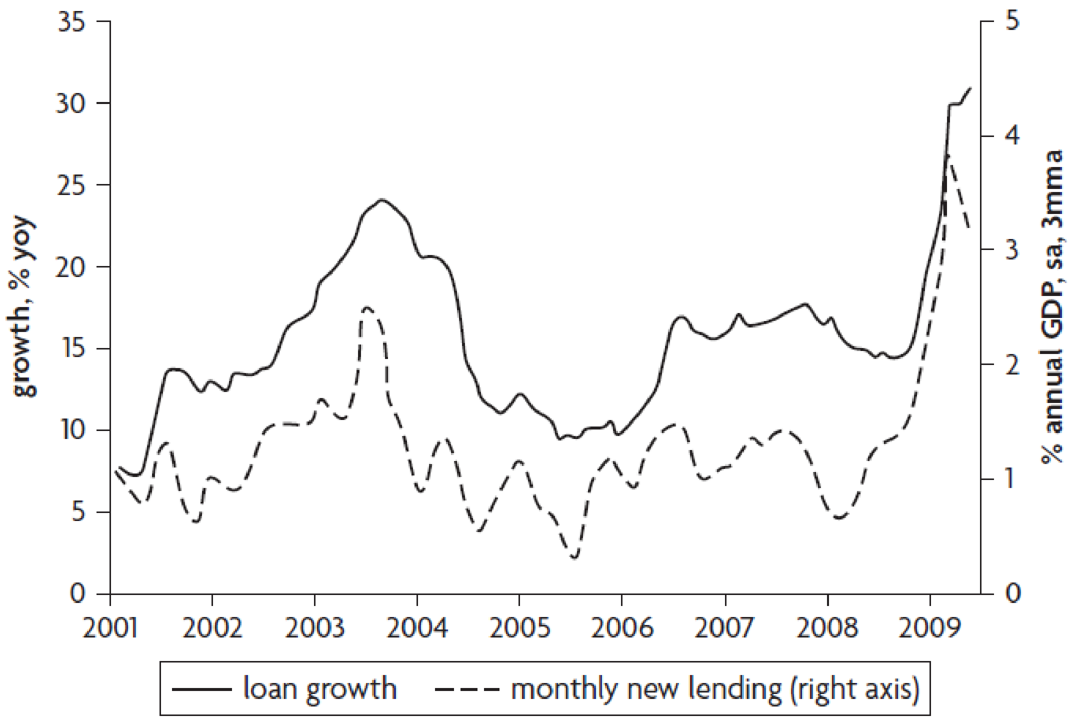
(% change from previous year period)

	2008				2009	
	Q1	Q2	Q3	Q4	Q1	Q2
M1	18.0	14.0	9.2	9.0	17.0	24.8
M2	16.2	17.3	15.2	17.8	25.4	28.4
Bank loans	14.8	14.1	14.5	18.8	29.8	34.4

Source: CEIC China Database; World Bank staff estimates.
Note: M1 = money supply; M2 = M1 plus quasi-money.

The aggressive easing of monetary policy supported an extraordinary expansion in bank lending. The year-on-year increase in bank lending climbed from 18.8 percent in the last quarter of 2008 to 29.8 percent in the first quarter of 2009—and to 34.3 in the second quarter. New lending amounted to about 30 percent of GDP in 2009 (figure 10).

Figure 10. New Banking Lending



Sources: CEIC China Database; World Bank staff estimates.
Note: mma = monthly moving average, sa = seasonally adjusted.

To ease bank lending in late 2008, the central bank lifted credit quotas and cut interest rates five times (by a total of 216 basis points) during September–December. In large part, the injection came about because of lower required reserve ratios, which went from 17.5 percent to 14–15 percent. Most banks have sizable capital bases and, so far, low nonperforming loans. Loan-loss reserves have also been increased. Bank profits are, however, being squeezed by falling loan rates and higher provisioning costs, and many need to raise capital after the lending surge.

China's effective exchange rate continues to hover around its U.S. dollar peg. Since the end of 2008, the renminbi has been repegged to the dollar. However, a large and increasing part of China's trade is with countries other than the United States. Thus, as a result of the dollar's movement relative to other currencies, changes in China's trade-weighted exchange rate have differed significantly from movements against the dollar. China's nominal effective exchange rate (NEER) appreciated 12.3 percent between July 2005 and early March 2010, after depreciating in 2000–05, and is now roughly at the level prevailing in 2000 (figure 5). This is also true for the Consumer Price Index–based real effective exchange rate (REER). Moreover, large movements in the U.S. dollar versus other currencies have meant that since the repegging against the dollar at the end of 2008, the renminbi has moved up and down recently against the currencies of most of its trading partners. With respect to China's largest trade partner's currency, the EU's euro, the renminbi has appreciated since November 2009.

Fiscal expansion. China's fiscal policy response to the crisis has been bold and effective. In November 2008, the government announced a two-year fiscal stimulus package amounting to Y 4 trillion (US$590 billion). The expansionary fiscal policy aimed to dampen the impact of falling exports and weaker private domestic demand (box 2).

Substantial fiscal space combined with strong external confidence allowed the authorities to adopt such a large fiscal package. China had huge fiscal space (unlike most other emerging countries) thanks to its high level of domestic savings, strong external confidence, and low interest rates and spreads. Furthermore, a long track record of fiscal discipline has reduced public debt, allowing China to increase spending and lower taxes without triggering fiscal sustainability concerns. This is true even though total public debt is higher than the headline number of 20 percent of GDP, including the debts incurred by investment platforms associated with local governments.

In addition to the magnitude of the fiscal stimulus, the government front-loaded investment spending and deployed it rapidly. Starting in the last quarter of 2008, the quickly deployed public investment included major infrastructure projects and rebuilding efforts after the Sichuan earthquake.[10]

Additional measures supported domestic demand more generally. These included lower taxes, subsidies, and pension increases. Other fiscal policies targeting specific industries were also introduced. Strategic plans have been designed to support individual industries—retooling factories, improving energy efficiency, encouraging innovation and research and development spending, and consolidating those industries with excess capacity.

China's fiscal stance has changed dramatically with the stimulus that has boosted aggregate demand. The country's robust growth in 2009 was linked to a massive investment-led stimulus (5.9 percent of GDP) centered on infrastructure, combined with increases in transfers, consumer subsidies, and tax cuts. Only a small portion of the fiscal stimulus was reflected in the budget; the deficit rose moderately from 0.4 percent of GDP in 2008 to 2.8 percent in 2009. Bank lending contributed most of the fiscal stimulus (almost two-thirds) and the lending surge was fairly broad-based: infrastructure made up half of total medium- and long-term lending in 2009, but medium- and long-term lending to manufacturing, real estate (including mortgages), and other sectors also more than doubled (figure 11).

Box 2. China's Fiscal Stimulus Package

In November 2008, the government announced a bold two-year fiscal stimulus package amounting to Y 4 trillion (about US$590 billion, or 12.5 percent of 2009 GDP). The central government accelerated the approval process for new projects. The package also envisaged a significant share of the investments being implemented by local governments. The budget allocation under the stimulus package is summarized in table B2.1.

Table B2.1 Budget allocation under the government of China stimulus package

	Budget, yuan billions	% of total
Total stimulus package, 2008 Q4 to 2010 Q4	4,000	100
Central government new investments	1,180	30
Strategic investment		
Public housing	400	10
Rural infrastructure (electricity, water, and roads)	370	9
Transport and big infrastructure projects (railway, road, airport, irrigations and electricity grid)	1,500	38
Health and education (including building schools and hospitals/clinics)	150	4
Energy and environment (including water and sanitation, sewage, and restoration)	210	5
Technological innovation	370	9
Postearthquake reconstruction	1,000	25

Source: National Reform and Development Commission website, http://en.nrdc.gov.cn.

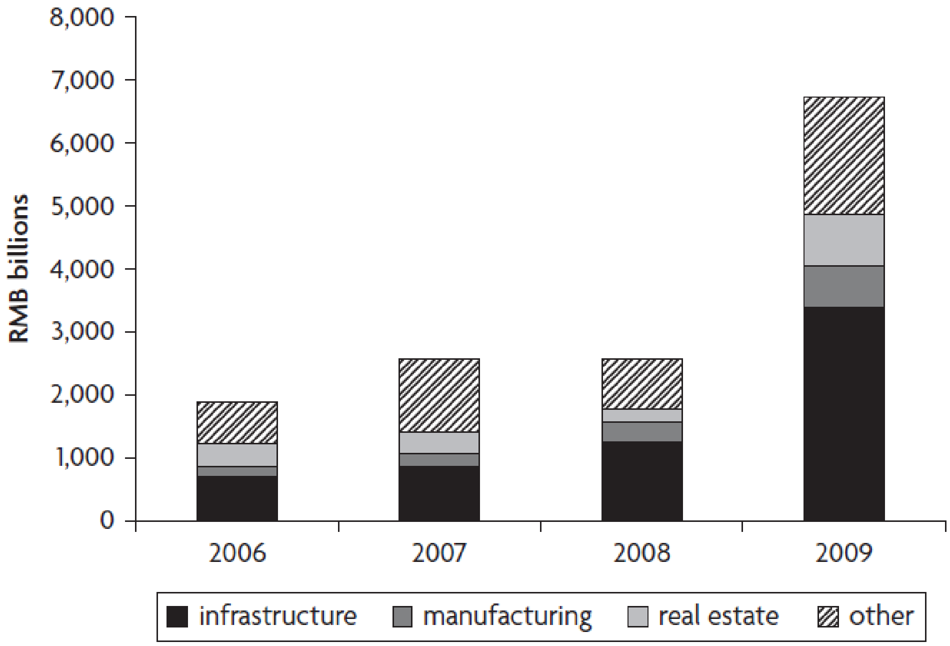
The Y 4 trillion fiscal stimulus package includes the following components:

- Infrastructure (including rural), transport, and energy investment projects account for 52 percent of the total; this share rises to 77 percent if postearthquake reconstruction spending is added.
- Central government's new investment amounts to Y 1.18 trillion (US$173 billion); Y 104 billion (US$15 billion) was spent in 2008, Y 487.5 billion (US$71 billion) is budgeted for 2009, and Y 588.5 billion (US$86 billion) will be spent in 2010.
- Investments in fixed assets, such as machinery and equipment, were also further encouraged through reforms to the value added tax (VAT), which the government estimated would reduce the corporate tax burden by Y 120 billion (US$18 billion) in 2009.

The impact of the consumption-oriented fiscal measures is more modest. Despite the overwhelming focus on investment, some consumption and social welfare programs are being developed:

- The government has sharply increased financial support for low-income groups and subsidies for the rural sector, including a program that provides a 13 percent subsidy on home appliances (color TVs, refrigerators, washing machines, cell phones).
- In June 2009, the State Council approved a pilot scheme to launch a trial of rural pensions. The amount allocated by the federal government starts out small (about Y 3 billion), but the government plans to extend the program to all rural areas and supplement it with local government budgets; it also includes a self-funded component.
- Earlier in 2009, the government announced a health care reform plan to make health care more accessible and affordable. Spending commitments under this plan are sizable, including wider coverage for medical insurance.

Figure 11. New Medium- to Long-Term Banking Lending, 2006–09



Source: The People's Bank of China; World Bank staff estimates.

Overall, China has shown a large capacity for countercyclical fiscal spending, especially on government investment projects (notably, infrastructure) that have helped put the economy back on a growth path. Besides the positive, short-term Keynesian impact on aggregate demand, which was felt in late 2008 and in 2009, infrastructure investments also tend to be good for medium- and long-term growth, as they relieve constraints by boosting productive capacity and GDP potential.

Although the impact of consumption-oriented fiscal measures was more modest, household consumption growth has remained steady. After weakening in early 2009, labor market conditions have improved and employment and wage growth have held up well through early 2010. Income and consumption have also been further supported by falling consumer prices during much of 2009, which boosted purchasing power; higher government transfers; lower consumption taxes for small cars; and subsidies for rural consumption of electronic appliances.

IV. China's Short- and Medium-Term Prospects

China's large fiscal and monetary stimulus has supported an economic recovery, despite the sharp fall in exports associated with the global recession. The stimulus was the main cause of China's real GDP growth of 8.7 percent in 2009. Although most of the stimulus has shown up in infrastructure-oriented, government-sponsored investment, some has been consumption-oriented; and domestic demand growth has been broad-based. Consumption has remained robust, in large part because the labor market has held up well. The strong domestic demand has buoyed import volumes, and the current account surplus narrowed to 6.1 percent of GDP from 11 percent of GDP in 2007, even with sharp declines in import prices.

Short-Term Outlook

Real GDP growth is likely to remain strong this year, with the composition of growth set to shift markedly. The strong growth momentum at the end of 2009 carried into the first months of 2010, with particularly strong exports, retail sales, and industrial production. We project real GDP growth of 9.5 percent for 2010 as a whole. Exports are set to grow robustly as global demand recovers. Although imports should outpace exports somewhat, net external trade should add modestly to real GDP growth. Real investment growth, however, may be only about half the rate it was last year. In a heated housing market, real estate investment should grow well. On the other hand, government-led investment—the key driver of growth in 2009—is bound to decelerate considerably. In 2011, we expect overall GDP growth to remain strong, with a broadly similar composition as this year's.

With this scenario, the trade surplus (in U.S. dollar terms) may narrow in 2010 because of a projected decline in the terms of trade. The current-account surplus may expand somewhat this year and the next, owing mainly to higher income earned on China's foreign reserve holdings.

While inflation has turned positive, it is likely to remain modest in 2010. Consumer prices picked up in the second half of 2009, led by higher food prices. Nonetheless, inflation will likely average a modest 3.5–4 percent in 2010 as global price pressures remain subdued, China-specific factors behind food price increases abate, and the authorities act decisively to curb core inflation pressures.

The heated real estate market, however, will keep property prices rising rapidly. Prices in the large cities in February 2010 averaged more than 30 percent above those of the previous year, and further increases are in sight. This has prompted policy measures to expand supply and curb speculation, although the government is cautious in its policy response and does not want to reduce real estate activity.

China will need to take a less accommodative macroeconomic policy stance in 2010 to contain the emerging risks. The world economy is still subdued, with output below potential in many countries. China's growth, however, has been strong and, unlike most other countries, its overall output is near potential. The absence of a significant output gap means that China needs to assume a macroeconomic stance different from that of most other economies. Even though inflation risks remain modest because of the weak global environment, the macro stance should be considerably tighter in 2010 than in 2009; this will be necessary to manage inflation expectations and contain the risks of a property bubble and strained local government finances.

In general, the key economic issues in China are quite different from what they are in most other countries:

- *The 2010 budget presented to the National People's Congress rightly implies a broadly neutral fiscal stance.* The 2010 fiscal deficit is now targeted to remain largely unchanged from 2009. However, world economic prospects are still uncertain, and flexibility in implementation is important. This points to the need for contingency plans and, equally important, room for automatic stabilizers to work.

- *Monetary policy needs to be tighter than last year, and the case for exchange rate flexibility and increased monetary independence from the United States (and the dollar) is getting stronger.* A higher renminbi exchange rate can help reduce inflation pressures and rebalance the economy. The case for a larger role for interest rates in monetary policy is strong. Also, if policy makers remain concerned about interest rate–sensitive capital flows, more exchange rate flexibility would help.
- *Given that most of the stimulus package took the form of increased bank lending, concerns have arisen about the effect this will have on the quality of bank portfolios.* A potential risk is that overall economic growth in China could markedly slow in 2010 (and beyond), cutting into the profits of private and state entities, which would in turn create problems in repaying outstanding bank loans. This risk appears minimal, however, and building on the momentum shown in the first months of 2010, economic growth is likely to remain strong in 2010 (9.5 percent). Another mitigating factor is the expected deceleration of government-led investment, the driver of credit growth in 2009. Furthermore, the authorities have outlined a less expansionary monetary policy stance for 2010: overall credit growth is targeted at about 18 percent (versus 30 percent in 2009), monthly credit quotas should keep lending growth in check, and the reserve-requirement ratio has been raised twice to withdraw liquidity.
- *Ensuring financial stability includes mitigating the risk of a property price bubble and ensuring the sustainability of local government finances.* With regard to the property market, stability calls for an appropriate macro stance and improving the functioning of markets. Concerns about the affordability of housing for lower-income people are best addressed by a long-term government support framework. The authorities have rightly increased vigilance over lending by local government investment platforms. Given China's solid macroeconomic position, local financial problems are unlikely to cause systemic stress; however, the flow of new lending to the various platforms needs to be contained, and local government revenues need to be less dependent on land transaction revenues.

In the medium term, China's recovery can be sustained only with a successful rebalancing of its economy. This calls for more emphasis on consumption and services and less on investment and industry. As China's leaders (including Premier Wen Jiabao) have noted, the global crisis makes rebalancing China's economy all the more urgent. This is because global demand and export growth are expected to be weak, even in the medium term—reducing GDP growth, all else being equal.[11] In addition, China's rebalancing will be helpful in addressing the global imbalances, whose resolution requires that countries like China pursue policies to lower their surpluses.

Following on earlier initiatives, the government took steps in 2009 to rebalance and boost domestic demand. For example, it expanded the role of the government in financing health, education, and social safety nets; improved access to finance and small and medium enterprise development; and contained resource use and environmental damage. These are useful steps, but more policy measures are needed to rebalance growth, given the strong underlying momentum of the traditional pattern. More must be done in all these areas.

More generally, in the years ahead, China will need to undertake two types of structural reform to ensure a successful economic rebalancing and sustained growth:

- *Policy reforms to help channel resources to sectors that should grow in the new environment, instead of to sectors that have traditionally been favored and done well.* Financial sector reform can improve the allocation of capital (and access to finance) for the private sector, service-oriented and smaller firms, and households. Also, the expansion of the dividend payment policy for SOEs can improve the allocation of SOE profits. Adjustment of prices and taxation of resources and strengthening of the renminbi exchange rate can shift production from industry to services. A stronger real exchange rate would support consumption by reducing the prices of tradable goods domestically and increasing labor income at home. It would also give incentives for greater investment in domestically oriented sectors by increasing their relative competitiveness. Thus, despite the problems that it may cause for exporters, further real appreciation of the renminbi is desirable, given China's policy priorities. In addition, opening up several service sectors to the private sector and removing unnecessary regulation and restrictions could boost growth and employment.
- *Policy reforms to support more thriving domestic markets; to encourage successful, permanent urbanization; and to achieve a more vigorous, services sector–oriented domestic economy.* China needs more migrants to settle permanently in the cities. Urban dwellers consume more than rural people and spend much more on services. In addition to opening up services sectors, other key policies to promote successful, permanent migration are further liberalization of the Hukou (household registration) system; land reform; and reform of the intergovernmental fiscal system (to give municipalities the resources and incentives to provide basic public services to migrants). Significant increases in household debt are also feasible. In 2007, the household debt-to-GDP ratio was below 20 percent in China, compared with 100 percent in other Asian countries, and 110 percent in the United States and United Kingdom (see Lardy 2009). With regard to international economic relations, China must (as its leaders have stressed) avoid protectionism, as exports are critical to the recovery of the world economy.

Medium-Term Outlook

Successful implementation of the reforms cited above cannot be taken for granted. Nonetheless, China's medium- and long-term economic prospects look good, as they continue to be supported by broadly appropriate economic policies and institutions and a capable government.

Our medium-term projections on the expenditure components of GDP are based on the following assumptions:

- *Private consumption grows broadly in line with real household income.* As to its determinants, our medium-term outlook for the urban labor market suggests continued robust wage and employment growth. Moreover, further fiscal support to household disposable income is expected in the coming years, with continued—and substantial—increases in government spending on health, education, and social security (even though the overall fiscal stance is expected to remain broadly neutral).
- *The rebalancing of the pattern of growth planned by the government is likely to lead to a somewhat declining share of investment to GDP in the medium term.* However, boosted by the 18 percent investment surge in 2009, the starting level is high, and expectations for

investment remain strong. Investment is thus likely to continue growing robustly in the coming years.

- *Exports depend on the strength of world imports.* China's exports have continued to gain market share, and we expect Chinese exports to continue gaining market share in the coming six years—but at a slower pace, owing to saturation effects. In addition, overall market growth is likely to be more subdued than in the past 10 years. In all, in this scenario real export growth is expected to taper off to about 6.5 percent by 2015.
- *Sustaining past patterns, processing import volumes*[12] *will grow broadly in line with processing export volumes, and nonprocessing imports (used in the domestic economy) will grow broadly in line with domestic demand.* In all, we expect imports to outpace exports somewhat in the medium term, reflecting substantial growth differentials between China and the rest of the world, and some rebalancing. Given this assumption, China's trade surplus in our scenario is smaller compared to the precrisis levels.

Based on these assumptions and projections, GDP growth in China would taper off from 9.5 percent in 2010 to 7.5 percent in 2015. Table 2 presents the main variables of the medium-term scenario.

At the same time, we also expect China's potential output growth to slow during 2010–15. The investment projections mentioned above imply a mild decline in the ratio of investment to GDP. On this basis, increases in the capital-to-output ratio are expected to moderate but remain substantial, thus representing a significant contributor to productivity and GDP growth. Demographic projections imply a further moderate decline in the growth of the working population and overall employment. TFP growth is assumed to slow somewhat, as the scope for reaping economies of scale in manufacturing may diminish, leading to a more subdued global trade outlook. But TFP growth should remain respectable as improvements in education continue to support human capital. In all, potential GDP growth would continue to approximate actual GDP growth, declining from about 10 percent in recent years to 7.7 percent in 2015.

Innovation, technological catch-up, and increased TFP will be critical factors in China's economic growth in the medium term. Concerns about job creation in the enlarged and more technologically advanced services sector will have to be addressed in the new industrial policy.

As noted earlier, China has seen a much milder recession than most other countries and a much smaller output gap; we project a continuing small output gap in the medium term. Actual overall output should also remain relatively close to potential output, continuing the track record since the late 1990s. Inflation is likely to remain moderate in the medium term, largely because of the subdued global inflation pressures expected in the coming years. In general, with growth and macro stability likely to remain in place, policy attention should shift to the structural reforms necessary to rebalance the economy and sustain productivity growth.

Table 2. China: Medium-term scenario 2010-15

(percent change, unless otherwise indicated)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010f	2011f	2012f	2013f	2014f	2015f
The real economy																
Real GDP	8.4	8.3	9.1	10.0	10.1	10.4	11.6	13.0	9.6	8.8	9.5	8.7	8.0	7.9	7.8	7.6
Domestic demand[a]	7.5	8.5	8.6	10.2	9.7	8.1	9.7	10.8	9.4	13.9	9.7	8.7	8.4	8.2	8.1	8.0
Consumption[a]	8.9	6.6	6.6	5.9	6.8	7.3	8.4	10.2	8.8	9.9	9.6	9.3	9.2	9.1	9.0	8.9
Gross capital formation[a]	5.2	12.0	12.1	16.9	13.6	9.0	11.1	11.4	10.2	18.3	9.7	8.0	7.5	7.3	7.1	6.9
Contribution to GDP growth (pp)																
Domestic demand[a]	7.4	8.3	8.4	9.9	9.5	7.9	9.4	10.4	8.8	12.8	9.1	8.3	8.0	7.9	7.8	7.7
Net exports[a]	0.0	0.0	0.7	0.1	0.6	2.5	2.2	2.6	0.8	–4.0	0.4	0.4	0.0	0.0	–0.1	–0.1
Contribution net exports (pp)[b]	—	—	—	—	—	—	3.8	3.5	1.8	–4.8	0.4	0.4	0.0	0.0	–0.1	–0.1
Exports (goods and services)[b]	30.6	9.6	29.4	26.8	28.4	24.3	24.0	20.0	8.6	–10.4	14.7	9.4	7.0	6.8	6.7	6.5
Imports (goods and services)[b]	24.5	10.8	27.4	24.9	22.7	11.4	16.1	14.2	5.1	4.3	16.4	9.2	8.3	8.2	8.1	8.0
Potential GDP growth	8.7	9.0	9.1	9.7	10.0	10.2	10.5	10.4	10.1	10.0	9.3	8.8	8.5	8.2	7.9	7.7
Output gap (pp)	–1.1	–1.8	–1.8	–1.6	–1.5	–1.3	–0.2	2.3	1.8	0.6	0.8	0.7	0.3	0.0	–0.2	–0.3
CPI increases (period average) (%)	0.4	0.7	–0.8	1.2	3.9	1.8	1.5	4.8	5.9	–0.7	3.7	2.8	2.8	2.8	2.8	2.8
GDP deflator	2.1	2.1	0.6	2.6	6.9	3.8	3.6	7.4	11.4	–2.1	2.8	2.6	2.3	2.0	2.0	2.0
External terms of trade	—	—	—	—	—	—	–0.8	–0.9	–4.3	8.6	–2.9	–0.1	1.1	0.7	0.7	0.7
Fiscal accounts (% GDP)																
Budget balance[c]	–2.5	–2.3	–2.6	–2.2	–1.3	–1.2	–0.8	0.6	–0.4	–2.8	–2.8	–2.8	–2.8	–2.8	–2.8	–2.8
Revenues	13.5	14.9	15.7	16.0	16.5	17.3	18.3	19.9	19.5	20.6	19.6	19.8	20.0	20.2	20.4	20.6
Expenditures	16.0	17.2	18.3	18.1	17.8	18.5	19.1	19.3	19.9	23.4	22.4	22.6	22.8	23.0	23.2	23.4
External account (US$ billions)																
Current account balance (US$ bn)	21	17	35	46	69	161	250	372	426	297	322	359	391	415	438	458
As share of GDP (%)	1.7	1.3	2.4	2.8	3.6	7.2	9.4	11.0	9.4	6.1	5.8	5.6	5.4	5.0	4.7	4.3
Foreign exchange reserves (US$ bn)	—	—	—	403	610	819	1,066	1,529	1,946	2,400	2,767	3,148	3,550	3,970	4,411	4,870
Other																
Broad money growth (M2), eop (%)	14.0	14.4	16.8	19.6	14.6	17.6	16.9	16.7	17.8	27.0	17.0	—	—	—	—	—

Source: NBS; The People's Bank of China; Ministry of Finance; World Bank staff estimates.

Note: The data are not adjusted for accumulation of arrears in tax rebates to exporters during 2000–02, and the repayment of these arrears in 2004 and 2005. Such an adjustment would increase the deficit in 2000–02 and lower it in 2004–05. f = forecast; — = not available.

a. World Bank estimations using data on contribution to growth (Table 2–20 in China Statistical Yearbook).

b. World Bank staff estimates based on trade data for goods from the Custom Administration, adjusted for estimated difference in price development for services trade.

c. For 2009 and 2010 this is the commitment data presented to the NPC.

A number of factors, however, pose risks to these benign medium-term scenarios. Externally, the world economy is slowly getting back on track but it will take a long time to normalize all financial and trade transactions. Since the second quarter of 2009, the world economy has shown notable signs of stabilization. Industrial production in industrial and emerging economies has recovered, the intermediation function of the financial system has increased, and trade has slowly picked up. However, achieving a comprehensive and broad-based recovery will be a slow, difficult, and complicated process, as Premier Wen Jiabao has indicated: “It would require long-term, concerted efforts by every country in the world.”

Domestically, while China’s financial sector has shown its resilience to the global turmoil, risks to credit quality exist. These stem from the recent massive growth in bank lending, especially lending for infrastructure projects, and the buildup of excess capacity in some tradable industries. Despite the signs of economic recovery, incentives for overinvestment are present. Therefore, policy makers should keep a watchful eye on the rapid credit growth and should strictly supervise banks.

Another domestic risk involves local government finance. As indicated in box 2, local government investment helped prop up growth in 2009. However, a significant portion of this investment (bank loans jumped to Y 7.4 trillion at the end of 2009 from Y 1.7 trillion at the end of 2007) was financed through the borrowings of urban development and investment companies used by local government (Wolfe 2010). If some of the projects financed by these loans prove unable to generate enough revenue, either the state-owned banking sector or central and local governments will have to take on the costs.

While progress has been made in increasing the market’s role in determining the exchange rate of the renminbi, China’s failure to make the exchange rate regime more flexible could increase the risks of macro vulnerability. A more flexible exchange rate policy would make monetary policy more independent, allowing it to mitigate the impact of external and domestic shocks (IMF 2009). This motivation has become more important as China’s cyclical conditions have diverged from those in the United States, which is the current anchor for monetary and exchange rate policy.

Finally, the Chinese authorities will have difficulty pursuing structural reforms in the face of resistance from those benefiting from current policies. For example, it may prove difficult to open up several services sectors to private sector participation or to reform the intergovernmental fiscal system to diminish fiscal inequality.

In sum, successful economic rebalancing could help China sustain medium- and long-term economic growth. Its success, however, depends mainly on the pace and sequence of domestic policies aimed at deriving more growth from consumption and less from investment and exports. Bringing about this change will have global implications. If it is achieved, and if it is combined with the successful rebalancing efforts of other countries, it will help reduce global current account imbalances and lead to a healthier pattern of global growth. For China, however, the more successful the rebalancing effort, the more sustainable will be its future growth path.

V. Summary and Concluding Remarks

Since the late 1970s, China has experienced impressive GDP growth, averaging 8.9 percent per year during 1995–2001. GDP growth accelerated even further during 2002–07, to an annual average of 11 percent. China's powerful investment-heavy, industry-led pattern of growth was fueled by the recovery from the Asian crisis, a strong reform agenda, and an active public investment program. Amid a favorable global environment characterized by expanding global demand, Chinese exports surged by about 20 percent annually during 2002–07. While China attracted a large amount of FDI during this period—equal to 3–4 percent of GDP—current account surpluses stayed large, averaging more than 6 percent of GDP. Domestic savings have been the key source of investment financing in China. Were it not for the global crisis, China's potential annual growth rate would have been about 10 percent.

When the crisis hit, China had strong macroeconomic fundamentals with large current account surpluses, low public and external debt, and substantial foreign exchange reserves. Moreover, China's limited exposure to toxic assets in the developed world and its relatively closed capital account shielded it from the initial financial turmoil of 2008. But beginning in November 2008, China's real economy began to feel the effects of the crisis, especially through the trade channel. Export growth plummeted in early 2009, contracting by 25 percent year on year. To counter the effects of the rapidly deteriorating economic conditions of late 2008, the Chinese authorities took strong and quick action: a huge fiscal stimulus package equivalent to 12.5 percent of 2008 GDP and a substantial loosening of monetary policy. The measures limited the impact of the crisis, and economic growth reached 8.8 percent in 2009.

Looking beyond the global crisis, the growth slowdown in advanced countries, and especially slower export demand, can be expected to have a significant impact on China's medium-term potential growth. All else being equal, we estimate that a 10-percentage-point drop in the growth of exports will result in a 2-percentage-point reduction in GDP growth over the medium term—down to about 8 percent annually.

While signs of stronger domestic demand were already evident in 2009, it remains unclear how much the recovery can be sustained in the absence of government stimulus. The government's ability to adopt a more active and sustained policy of rebalancing its economic structure away from dependence on exports and investment to domestic consumption, accompanied by other structural reforms, will be critical. Only such a rebalancing will mitigate the impact of the crisis and put China on a renewed long-term growth path.

End Notes

1. Concerns about the distributional impacts of the growth process have led to a debate. For a recent review, see Chaudhuri and Ravallion (2007).
2. This section draws on Kuijs (2005) and Kuijs and Wang (2006).
3. See Kuijs (2005) and (2009) for details.
4. The exact breakdown of the increase in China's domestic savings in recent years is not yet fully clear, with the headline national accounts data in the flow of funds difficult to line up with data from the household survey, the industrial survey, and fiscal information. Large discrepancies have also appeared in the flow-of-funds data themselves, suggesting that the asset data imply higher enterprise saving and lower household and government saving in recent years than the headline flow-of-funds data shown in figure 2.
5. A 2003 World Bank report concluded that "service sector development suffers from restrictions and regulation and a lingering bias against private ownership." The OECD (2005) saw similar room for improvement by removing entry and other barriers to the development of services industries.
6. This implication is from Aziz and Cui (2007).
7. The ratio of loans to GDP decreased from a peak of 130 percent in early 2004 to 92 percent in mid-2008.
8. At the end of 2007, gross external reserves were reportedly almost 700 percent of short-term external debt by remaining maturity.
9. Until the fourth quarter of 2008, the central bank had been pursuing a tight monetary policy to prevent a spiral of inflation expectations. These inflationary pressures were arising from food and commodity price increases and rising asset prices, and the tight monetary policy aimed to stop overheating in high-growth sectors. Controls on new lending and credit ceilings (partially voluntary) were put in place.
10. The quick response of government spending partially reflected the fact that a large share of the program had already been drafted for reconstruction after the earthquake in May 2008.
11. Guo and N'Diaye (2009) show that maintaining the current export-oriented growth over the medium to long term would require significant gains in market share through lower prices across a range of industries. This achievement, without consideration of the lower global demand following the current crisis, would necessitate higher productivity subsidies and lower profits. Evidence suggests it will be difficult to accommodate such price reductions. Furthermore, experiences from Asian countries also suggest that there are limits to the global share a country can attain.
12. Processing trade refers to importing all or part of the raw and auxiliary materials, parts and components, accessories, and packaging materials from abroad in bond, and reexporting the finished products after processing or assembly by enterprises in China.

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